



The Big Keep Getting Bigger: What Can be Done?
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Prior to departing the FDIC this coming July, FDIC Chairman Sheila Bair is focusing considerable attention on the resolution authority to be implemented under Dodd-Frank. The Act empowers the FDIC to take over and liquidate a failing institution under certain conditions. Two important components of the resolution authority are that the Financial Oversight Stability Council (FSOC) must formally designate specific firms as systemically important financial institutions (SIFIs) and that each firm so designated must prepare a formalized plan (living will) which specifies how the firm would be resolved if it falls into severe financial distress. There would presumably be no bailout as occurred in 2008-2009 when Too Big to Fail institutions benefited from extraordinary taxpayer assistance that was not available to other non-complex institutions.

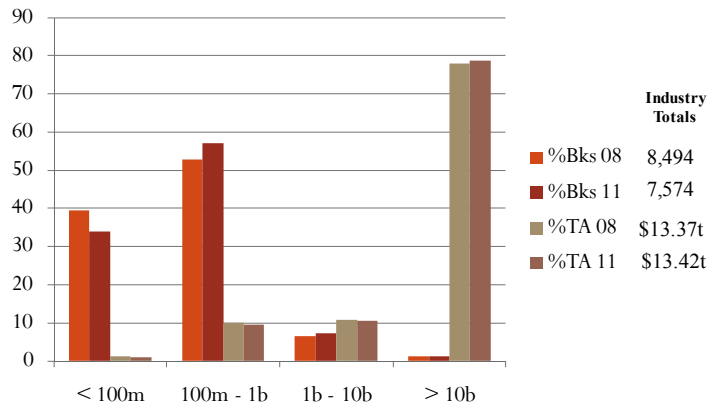
Something better happen soon to prevent a more severe impact from a future crisis. Exhibit 1 compares the proportionate number of institutions and share of total assets held by banks of different sizes as of March 2008 versus March 2011 which covers the early stage of the recent financial crisis to the most recent period for which data are available. While the total number of banks fell by 920, the proportion with less than \$100 million in assets fell by 5.4% while the proportions with assets between \$100 million and \$1 billion and \$1 billion to \$10 billion increased. The proportionate number of banks with more than \$10 billion in assets remained constant at 1.4%. This is not surprising given that banks generally grow over time and few new bank charters have been granted in recent years. However, the entire growth in proportionate holdings of industry assets occurred at banks with more than \$10 billion in assets.

This trend is stronger when comparing smaller bank performance against the four largest U.S. banks in 2011. Exhibit 2 demonstrates that the market share of total U.S. banking assets held by JPMorgan Chase, Bank of America, Citibank and Wells Fargo increased from 33.9% to 40.5% over the three years from the beginning of the crisis to March 2011. While Citibank's share fell by 1% over the period, the market shares of the other three sharply increased.¹ Thus, while all banks over \$10 billion increased their market share of assets by just under 1%, these four Too Big to Fail banks increased their market share by almost 7%. Clearly, the largest banks that contributed more to the financial crisis and received incredibly large amounts of emergency financing from different federal government programs and the Federal Reserve's discount window, are getting bigger. But are they stronger and less likely to pursue actions leading to another financial crisis?

¹ In 2009 Wells Fargo merged with Wachovia after the FDIC seized Wachovia's assets having declared the firm 'systemically important.' The FDIC initially sold Wachovia's banking operations to Citigroup but allowed the Wells Fargo merger as it didn't involve formal FDIC assistance.

Exhibit 1

Market Share of Different Size Banks: 2008 -2011 Q1

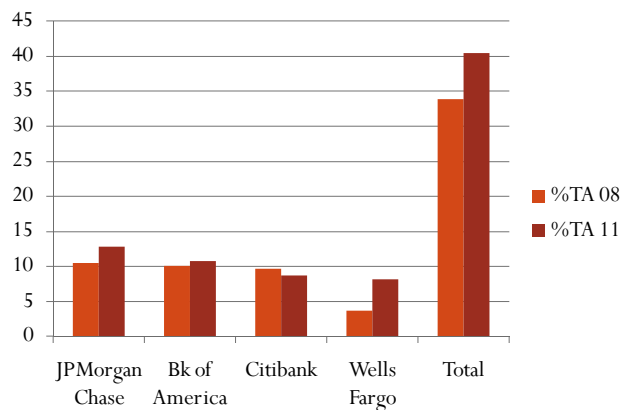


Millions (m), billions (b) and trillions (t) of dollars

Source: Quarterly Banking Profile, www.fdic.gov

Exhibit 2

Comparative Market Share of the Four Largest U.S. Banks: 2008 Q1 vs 2011 Q1



Source: Federal Reserve statistical release; total consolidated assets, March 31, 2008 and 2011

It is critically important that the resolution authority have ‘teeth’ and that government officials have the political will to implement the resolution process. FSOC must designate the appropriate banks and nonbank firms as SIFIs. Not surprisingly, many firms (hedge firms and the like) are lobbying extensively for exclusion from this group. SIFIs must similarly be held to the task of specifying how they would be resolved and restructure operations as appropriate.² Finally, many experts believe that SIFIs must be required to deleverage, that is, operate with higher amounts and proportions of common equity. A popular proposal is for SIFIs to be required to finance operations, in part, with contingent capital instruments that convert from debt to common equity when a firm gets into financial distress. Former FDIC Chairman, William Isaac, is further proposing that every SIFI be required to establish a ‘subsidy reserve’ on its balance sheet in an amount equal to the cumulative annual subsidy provided by taxpayers for being Too Big to Fail. This reserve would only be distributed in a failure or downsizing.

If done effectively, these steps may reduce the inappropriate benefits attributable simply to size and interconnectedness. Interestingly, no strong empirical evidence exists that large banks are more efficient in providing services or that the financial system needs such complex, interconnected institutions for financial markets to function smoothly. Remember what happened to large banks in Ireland and the U.K. whose governments had to assume ownership and/or obtain financial assistance from the European Union and IMF for the banks to continue operations. Similarly, the existence of Too Big to Fail institutions provides a substantial competitive advantage. Numerous studies have documented benefits from this implicit government guarantee including greater access to government emergency funding, lower borrowing costs and greater access to the capital markets – especially when trying to issue common stock. If these firms are unfettered, the benefits will increase over time. For example, how will the largest banks respond when unlimited deposit insurance on noninterest bearing transactions accounts goes away at the end of 2012? Many of them are already increasing the earnings credit provided in an effort to lock-in business customers. Firms without the implicit government guarantee don’t have this option.

Community bankers should continually question whether sufficient progress is being made:

- What are the criteria to determine which firms are SIFIs and are they appropriate?
- Are regulators enforcing requirements for the development of resolution plans?
- Are the living wills credible and sufficiently detailed? What are the costs when SIFIs don’t adequately fulfill these requirements?
- How can government officials and politicians be made aware of the costs of Too Big to Fail and be encouraged to enforce the resolution authority provisions?

² See “We Must Resolve to End Too Big to Fail,” remarks to the 47th Annual Conference on Bank Structure and Competition,” Federal Reserve Bank of Chicago, available at www.fdic.gov. Chairman Bair argues that the formation of detailed resolution plans by SIFIs along with pre-resolution planning in conjunction with on-site FDIC representatives will provide sufficient information to enable an orderly liquidation of the subject firm.